INTRODUCTION

• What is a production (severance) tax?
  • Tax is on the act of producing oil and gas
  • Tax is based on value of the resource as produced
  • Imposed under the State’s sovereign power to tax production not otherwise exempt
  • Generally in Alaska this means the tax applies to production after State and federal royalties (7/8 of production for most pre-1979 leases; less for post-1978 leases having higher exempt royalty rates)
Alaska’s production tax methodology has been substantially changed in recent years:

- Pre-February 2005: Economic Limit Factor (ELF)
- February 2005 – March 31, 2006: Aggregated ELF
- April 1, 2006 – July 2007: Petroleum Production Tax (PPT)
- July 2007 – 2013: Alaska’s Clear and Equitable Share (ACES) *
- 2014 – present: MAPA (SB 21) & SB 138

* Some provisions of ACES made retroactive to enactment of PPT, others to 1/1/2007
WHY THE ELF AND WHAT WAS IT?

• State wanted the production tax to be Alaska’s primary tax on production
  • As fields’ reserves are depleted, their economics deteriorate and tax relief becomes appropriate to prevent premature shut-in
  • Incentive to develop and produce smaller fields while keeping tax higher on larger, more prolific fields
WHY THE ELF AND WHAT WAS IT?

• Economic Limit Factor (ELF)

• Formulaic multiplier designed to reduce the effective production tax rate for a field as the field matures and becomes marginal

  • ELF tried to approximate the percentage of production value being consumed as the costs of producing that production

  • Production tax rate reduced to zero when the field was just breaking even

  • In essence, designed to allow the complete development of the field
WHY THE ELF AND WHAT WAS IT?

• Tax rate for a given field = ELF x its Base Rate
  
  • Oil: Base rate 12.25% for 1st 5 years, then 15%
  
  • Gas: Base rate 10%

• ELF basically a surrogate for deductions: tax rate reflected net operating margin after pipeline/tanker transportation costs and other limited costs

• Field-size added to oil ELF formula in 1989; in 2005 many North Slope fields were lumped together as one for ELF purposes
WHY THE PPT AND WHAT WAS IT?

- In 1995-2005 concerns arose over appropriateness of key statutory assumptions in the oil ELF formula
  - Kuparuk declined toward statutory 300 b/d per well break-even rate
  - “Field-size” made “small” fields too small
- Revenue decline, budget deficits and gas pipeline fiscal discussions
WHY THE PPT AND WHAT WAS IT?

- PPT was designed to deal with two major shortcomings many saw in the ELF
  - Create significant incentives to encourage exploration and development of oil and gas
  - Increase State tax take when oil and gas prices were high, regardless of the size or productivity of the field
WHY THE PPT AND WHAT WAS IT?

- PPT was dependent on the value of the oil and gas produced
  - Basically a tax on the value of oil and gas when severed from the reservoir
  - Allowed recovery of certain costs back to the bottom of the well

- State’s goal to raise industry taxes and PPT seen by some as necessary to help promote major gas development

- More than doubled industry’s taxes
PETROLEUM PRODUCTION TAX (PPT)

• Geographically based production tax versus a field-by-field determination
• Production/expenses treated separately for each of four “segments” within the state
  • North Slope
  • Cook Inlet Oil
  • Cook Inlet Gas
  • “Middle Earth”
PETROLEUM PRODUCTION TAX (PPT)

• Taxed a producer’s “production tax value” (PTV); i.e., value downhole at the point of severance from the reservoir

• Allowed deduction of most capital costs back to the well bottom versus operating costs only under ELF

• Certain tax credits allowed

• Small producer relief
PETROLEUM PRODUCTION TAX (PPT)

• Deductions and credits intended to encourage exploration/development

• Same tax rate for oil and gas from a given “segment”

• Created “progressivity”
WHY ACES AND WHAT IS IT?

- Alaska’s Clear and Equitable Share (ACES)
- Influenced by many factors:
  - Continued rising oil prices
  - Political scandals
  - Prudhoe Bay issues
  - Campaign rhetoric
WHY ACES AND WHAT IS IT?

- Administration and legislature's desire to increase taxes on industry
- Modified significant provisions of the PPT, including “progressivity”
- Added numerous confusing, complicated regulations
- Diluted many of the intended economic incentives envisioned under the PPT
- More than doubled industry’s taxes . . . again
HOW DOES THE PPT/ACES WORK?

• Gross Value of the oil and gas at the destination/market where it is delivered, sold or refined
  • **SUBTRACT**
    • Pipeline and marine transportation costs
    • Certain current year lease expenditures
      ◦ Certain current year operating expenses
      ◦ Certain current year capital expenses
  • **EQUALS** the Production Tax Value (PTV)
    • **TIMES** base tax rate
    • **ADD** progressivity tax, if applicable
    • **EQUALS** gross tax (or minimum tax (on gross value) if higher)
    • **SUBTRACT** allowable tax credits
• **EQUALS** the Production Tax due

NOTE: different rules apply to Cook Inlet production
HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

Gross value of the oil and gas at the destination/market **SUBTRACT**

**PPT (Key Provisions)**
- Pipeline and marine transportation costs
  - Pipeline tariffs and marine tanker costs

**ACES (Key Provisions)**
- Pipeline and marine transportation costs
  - Pipeline tariffs and marine tanker costs
  - Complicated by Department of Revenue (DOR) regulations
### HOW DOES THE PPT/ACES WORK?

**Gross value of the oil and gas at the point of production (Pump Station One)**

**SUBTRACT:**

<table>
<thead>
<tr>
<th>PPT (Key Provisions)</th>
<th>ACES (Key Provisions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certain current year operating expenses (opex)</td>
<td>Certain current year operating expenses (opex)</td>
</tr>
<tr>
<td>• Upstream of point of production</td>
<td>• Upstream of point of production</td>
</tr>
<tr>
<td>• Activity need not be physically on lease or property</td>
<td>• Activity need not be physically on lease or property</td>
</tr>
<tr>
<td>• 18 listed exclusions</td>
<td>• 21 listed exclusions</td>
</tr>
<tr>
<td>• Costs related to ULSD</td>
<td>• ULSD disallowed except for limited amounts</td>
</tr>
<tr>
<td>• Excess of FMV of internal/non-arm's length transactions</td>
<td>• Entire internal/non-arm's length transaction if in excess of FMV</td>
</tr>
<tr>
<td>• DOR allowed to use JIB's as starting point</td>
<td>• DOR not required/allowed to use JIB's</td>
</tr>
<tr>
<td>• DOR could issue regulations to clarify</td>
<td>• Costs related to interruption of production disallowed</td>
</tr>
<tr>
<td></td>
<td>• 2006-2009 legacy field “standard deduction”</td>
</tr>
<tr>
<td></td>
<td>• Deductions limited to those allowed by DOR</td>
</tr>
</tbody>
</table>
HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

Gross value of the oil and gas at the point of production (Pump Station One) \textbf{SUBTRACT}

**PPT (Key Provisions)**
- Certain current capital expenses (capex)
  - Must be capital expense
  - Same limitations as opex
  - Deductible even if tax credit allowed
  - 30¢ per BOE exclusion

**ACES (Key Provisions)**
- Certain current capital expenses (capex)
  - Must be capital expense
  - Same limitations as opex
  - Deductible even if tax credit allowed
  - 30¢ per BOE exclusion

\textbf{OIL & GAS: FUELING ALASKA’S ECONOMY}
HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

**EQUALS** the Production Tax Value

**PPT (Key Provisions)**
- Cannot be reduced below zero
- Any excess deductions creates NOL tax credit
- NOL Tax credit determined at 20% rate

**ACES (Key Provisions)**
- Cannot be reduced below zero
- Any excess deductions create NOL tax credit
- NOL Tax credit determined at base tax rate (25%)
# HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

TIMES the Base Tax Rate

<table>
<thead>
<tr>
<th>PPT (Key Provisions)</th>
<th>ACES (Key Provisions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• 22.5%</td>
<td>• 25%</td>
</tr>
<tr>
<td></td>
<td>• Special tax rate for non-Cook Inlet gas used in state</td>
</tr>
</tbody>
</table>
**HOW DOES THE PPT/ACES WORK? - NORTH SLOPE**

**ADD Progressivity**

<table>
<thead>
<tr>
<th><strong>PPT (Key Provisions)</strong></th>
<th><strong>ACES (Key Provisions)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• 0.25% per $1/BOE over $40 PTV determined monthly</td>
<td>• 0.4% per $1/BOE when PTV between $30-92.50 (25%) PLUS</td>
</tr>
<tr>
<td>• Total cannot exceed 25%</td>
<td>• 0.1% per $1/BOE when PTV greater than $92.50</td>
</tr>
<tr>
<td>• No brackets - all production taxed at highest rate</td>
<td>• Total cannot exceed 50%</td>
</tr>
<tr>
<td>• Maximum base &amp; progressivity - 47.5%</td>
<td>• No brackets - all production taxed at highest rate</td>
</tr>
<tr>
<td></td>
<td>• Maximum base &amp; progressivity - 75%</td>
</tr>
</tbody>
</table>

How does the PPT/ACES work?

ADD Progressivity

- PPT (Key Provisions)
  - 0.25% per $1/BOE over $40 PTV determined monthly
  - Total cannot exceed 25%
  - No brackets - all production taxed at highest rate
  - Maximum base & progressivity - 47.5%

- ACES (Key Provisions)
  - 0.4% per $1/BOE when PTV between $30-92.50 (25%)
  - PLUS
  - 0.1% per $1/BOE when PTV greater than $92.50
  - Total cannot exceed 50%
  - No brackets - all production taxed at highest rate
  - Maximum base & progressivity - 75%
### HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

**EQUALS** Gross Tax / OR Minimum Tax if greater

#### Minimum Tax Provisions

<table>
<thead>
<tr>
<th>PPT (Key Provisions)</th>
<th>ACES (Key Provisions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-4% of gross value at point of production</td>
<td>0-4% of gross value at point of production</td>
</tr>
<tr>
<td>Depending on price of ANS</td>
<td>Depending on price of ANS</td>
</tr>
<tr>
<td>Only on North Slope production</td>
<td>Only on North Slope production</td>
</tr>
</tbody>
</table>
HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

SUBTRACT allowable tax credits

PPT (Key Provisions)
- 20% of current year qualified capex spend
- NOL tax credits from prior years
- Small producer tax credits
- Purchased tax credits
- Exploration tax credits (20%, 30% or 40%)
- Transition investment tax credits

ACES (Key Provisions)
- 20% of current year qualified capex spend - over 2 years
- NOL tax credits from prior years
- Small producer tax credits
- Purchased tax credits
- Exploration tax credits (20%, 30% or 40%)
- TIE credits eliminated after 2007 except for first time explorers

EQUALS the Production Tax Due
HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

Statute of Limitations for audits

**PPT (Key Provisions)  
• 3 years**

**ACES (Key Provisions)  
• 6 years**
HOW DOES THE PPT/ACES WORK? - NORTH SLOPE

Interest on Retroactive Application of Tax Regulations

PPT (Key Provisions)
- Applicable

ACES (Key Provisions)
- Not applicable if good faith compliance (2010)
WAS ACES WORKING?

• ACES highest state tax – no other state tax even close
• Production decline continued at alarming rate
  • Annual reinvestments at risk
  • TAPS issues
• Exploration activity continued to fall
  • Key explorers looking elsewhere
    • OCS focus
    • Drill rig counts
  • Industry spend on current infrastructure and current resource base – not resource additions
• Regulatory uncertainties complicate administration/potential incentives
• Alaska investment climate/fiscal regime rated near bottom
WHY MAPA AND WHAT IS IT?

• More Alaska Production ACT (MAPA)

• Influenced by many factors:
  • Continued liquids production decline
  • Alaska falling in state rankings for production while investment and production in other states booming
  • Investment tax credits incentive not tied to increased production and hurting state revenues
WHY MAPA AND WHAT IS IT?

• Influenced by many factors:
  • Focus on increasing production to yield increased future revenues and jobs
  • Maintain competitive tax structure at both high and low oil prices
  • Insure Alaska remains competitive into the future
## KEY CHANGES UNDER MAPA

<table>
<thead>
<tr>
<th>ACES</th>
<th>MAPA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unbracketed Progressivity</td>
<td>No tax rate progressivity</td>
</tr>
<tr>
<td>25% Base Tax Rate</td>
<td>35% Base Tax Rate</td>
</tr>
<tr>
<td>75% Maximum Combined Tax Rate</td>
<td>35% Maximum Tax Rate</td>
</tr>
<tr>
<td>20% Investment (Capex) Tax Credits</td>
<td>No Investment (Capex) Tax Credits</td>
</tr>
<tr>
<td>Exploration tax credits (20%, 30% or 40%)</td>
<td>20-30% Gross Revenue Exclusion Incentive for New Production</td>
</tr>
<tr>
<td></td>
<td>Sliding Scale Per Barrel Tax Credit for Post 2013 Production</td>
</tr>
<tr>
<td></td>
<td>Production Tax Credits Not Available Against Minimum Tax</td>
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<tr>
<td></td>
<td>In-State Manufacturing Income Tax Credit</td>
</tr>
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<td>Competitiveness Review Board</td>
</tr>
</tbody>
</table>
WHY SB 138?

• Designed to progress Alaska LNG (AKLNG) Project

• Key Changes:
  • Allowed State participation in the project
  • Allowed State to ensure its gas supply by authorizing DNR to consider changes in certain royalty provisions and DOR to take project production tax as gas
WHY SB 138?

• Key Changes (con’t):
  • Fixed gas production tax rate at 13% on gross value versus PTV
  • State participation share ~25% (royalty + production tax)
  • Ensured no adverse impact to state oil and gas corporate income tax
  • No changes to current oil and gas property tax on existing properties
ARE MAPA AND SB 138 CHANGES WORKING?

• Industry investment is up, and oil production is predicted to increase

• AKLNG Project progressing and further along than any other major gas pipeline project before